IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF DELAWARE

IN RE:	:	
	:	Chapter 11
PILLOWTEX, INC., et al.,	:	
	:	Case No. 00-4211 to
	:	00-4234-SLR
Debtors.	:	

MEMORANDUM ORDER

At Wilmington this 4th day of June, 2002, having reviewed the motions by South Trust Bank and DukeSolutions, Inc. to compel the payment of post-petition rent or of adequate protection; and having conducted hearings on such;

IT IS ORDERED that said motions (D.I. 457, 1167) are denied, for the reasons that follow:

1. Movant DukeSolutions, Inc. ("Duke") entered into a Master Energy Services Agreement (the "MESA") with debtor Pillowtex Corporation ("Pillowtex") in June 1998. (D.I. 457, Ex. A) Pursuant to the terms and conditions of the MESA, Duke agreed to install certain equipment anticipated to improve energy consumption or to otherwise reduce the operating/ production costs at various Pillowtex facilities. The energy-savings equipment included certain lighting fixtures, T8 lamps and electronic ballasts (collectively, the "Lighting Fixtures"). The Lighting Fixtures eventually were installed in several Pillowtex facilities.

2. The cost of the acquisition and installation of the Lighting Fixtures was paid by Duke. (D.I. 457, Ex. A, ¶ 4.1(d)) According to an Energy Solutions Report (the "ESR") prepared to analyze the potential cost savings of the "lighting upgrades," the total cost incurred by Duke for acquisition and installation of the Lighting Fixtures was approximately $8.75 million, approximately $4.29 million of which was for labor and $4.46 million of which was for the lighting equipment. (D.I. 457, Ex. B at 3 and Table 1) Pillowtex, in turn, agreed to pay Duke on a monthly basis one-twelfth of the annual targeted savings detailed in the ESR until the end of the term. (D. I. 457, Ex. A, ¶¶ 6.2, 7.18; D.I. 746 at 17) Accordingly, for each lighting project (facility), Pillowtex and Duke agreed to a predetermined level monthly payment amount required to be paid to Duke. With respect to the term of each lighting project, the MESA provides that the term shall not exceed eight years and the simple payback of all of Duke's costs for the project shall not exceed five years. (D.I. 457, Ex. A at ¶¶ 4.1(a) and (f)) In other words, the payments were structured to ensure that Duke recouped its total costs and would receive certain set addition amounts within the term of each lighting project. (D. I. 746 at 11-12)

3. At the end of the term of each lighting project (the project for each facility), Duke had the option to: (a) pay for removal of the Lighting Fixtures and replace these fixtures

with equipment comparable to what was previously in place; (b) abandon the Lighting Fixtures; (c) extend the term of the MESA for such additional periods and payment terms as the parties agreed; or (d) permit Pillowtex to purchase all (but not less than all) of the Lighting Fixtures at a mutually agreed upon price. (D.I. 457, Ex. A at ¶ 8.3; D.I. 746 at 13-15)

4. Subsequent to execution of the MESA, Duke entered into a Master Lease Agreement with General Electric Capital Corporation ("GECC") dated August 2, 1999 (the "Master Lease"), pursuant to which GECC agreed to finance the Lighting Fixtures for four of the nine facilities in which Duke was to install new fixtures under the MESA and ESR. (D.I. 457, Ex. C) Duke and GECC also executed Equipment Schedule No. 001, which lists the Lighting Fixtures subject to the Master Lease. GECC and Duke agreed to an eight-year "lease" term with level monthly payments to be repaid out of the monthly payments made by Pillowtex to Duke under the MESA. (D.I. 457, Ex. C, Equipment Schedule No. 001 § B) At the conclusion of the Master Lease, Duke had the option to purchase all of the Lighting Fixtures at their fair market value as mutually agreed upon between Duke and GECC. If the parties could not agree upon a purchase price, an independent appraiser would make the purchase price determination. If Duke did not exercise the purchase option, Duke was obligated to pay for removal of the Lighting Fixtures and turn them over to GECC.

5. Concurrent with the execution of the Master Lease and the Equipment Schedule No. 001, Duke and GECC entered into a Collateral Assignment Agreement (the "Collateral Assignment"), whereby Duke granted GECC a security interest in and to all of Duke's right, title and interest in and to the MESA and ESR (including Duke's right to payment thereunder), and any and all products and proceeds of the foregoing as security for Duke's obligations under the Master Lease. (D.I. 457, Ex. D)

6. Pursuant to an "Acknowledgment Letter," Pillowtex acknowledged that GECC agreed to provide financing for the acquisition of the Lighting Fixtures and that Pillowtex's interest in the Lighting Fixtures financed by GECC was subject and subordinate to GECC's rights under the Master Lease and the Collateral Assignment. (D.I. 457, Ex. E)

7. On or about August 12, 1999, GECC and South Trust Bank ("South Trust") executed a Master Assignment Agreement ("Master Assignment"), pursuant to which GECC assigned to South Trust all of its rights, obligations, title and interest in the Master Lease, the Collateral Assignment, and certain other documents. (D.I. 457, Ex. F)

8. Debtors have not made any payments under the MESA for the Lighting Fixtures since filing for bankruptcy.

9. **Legal Analysis**. Pursuant to § 365(d)(10), a debtor is required to "timely perform all of the obligations of the debtor . . . arising from or after 60 days after the order for relief in a case under Chapter 11 of this title under an unexpired lease of personal property . . . until such lease is assumed or rejected. . . ." Therefore, if the MESA and Master Lease are true leases (as movants contend), debtors must perform their obligations thereunder until the leases at issue are assumed or rejected. Conversely, if these documents constitute security agreements (as asserted by Pillowtex), § 365 does not apply.

10. Under relevant case law,[1] courts will look to various factors in evaluating the "economic reality of the transaction . . . in determining whether there has been a sale or true lease," Pactel Fin. v. D.C. Marine Serv. Corp., 518 N.Y.S.2d 317, 318 (N.Y. Dist. Ct. 1987), including the following: "[a] whether the purchase option price at the end of the lease term is nominal; [b] whether the lessee is required to make aggregate rental payments having a present value equaling or exceeding the original cost of the leased property; and [c] whether the lease term covers the total useful life of the equipment." In re Edison Bros. Stores, Inc., 207 B.R. 801, 809-

[1]The parties to the agreements at issue have chosen the law of New York to govern their dispute.

10 and n.8, 9, 10 (Bankr. D. Del. 1997). See also N.Y.U.C.C. § 1-201(37) (McKinney Supp. 1996). "In this regard, courts are required to examine the intent of the parties and the facts and circumstances which existed at the time the transaction was entered into." In re Edison, 207 B.R. at 809.

11. Although the record is less than clear, it is the court's understanding that the MESA covered at least two different sets of energy services projects. One set of projects involved production or manufacturing equipment ("Production Equipment"); a second set of projects involved energy savings equipment, including the lighting upgrade project. There apparently is no dispute that, with respect to the Production Equipment, "Pillowtex was only interested in Duke originating funding for operating leases (or true leases) rather than capital leases (or financing transactions)." (D.I. 1383, Ex. A at ¶ 3; D.I. 1414, Ex. A at ¶ 5) According to Pillowtex, it entered into separate Production Equipment leases, each of which was recorded as a true lease on Pillowtex's books. (D.I. 1383, Ex. A at ¶ 7; D.I. 487, Ex. A, Appendix C) The parties, however, dispute whether the transaction was structured to account for the lighting upgrade project in a similar vein.

12. Movants contend that "Pillowtex and DukeSolutions structured the MESA to qualify, both in form and substance, as a true lease (rather than a debt financing) for both the Energy

Equipment and the Manufacturing Equipment." (D.I. 1414, Ex. A at ¶ 7) In support of this contention, movants refer the court to certain language in the MESA. For instance, Section 11.0 of the MESA provides that "[t]itle to the Equipment shall at all times remain in the name of DukeSolutions (or the Lender or Lessor providing financing for the Equipment) and Customer shall, at Customer's expense, protect and defend the title of DukeSolutions." Section 9.13(ii) provides that "neither Customer nor any sublessee nor assignee of Customer will at any time during the term of this Agreement claim to be the owner of the Equipment for income tax purposes under the laws of any jurisdiction." Finally, movants refer to Section 8.3, the termination provisions, by which Pillowtex is bound neither to renew the lease for the remaining economic life of the Lighting Fixtures nor become the owner of such. (D.I. 457, Ex. A at ¶ 8.3) In sum, movants argue that the parties' intent and commercial expectations were accurately reflected in the MESA which, as written, is a true lease.

13. Not surprisingly, Pillowtex focuses on the "economic realities" of the transaction, rather than on the form of the transaction. According to the evidence submitted by Pillowtex, there is no economic motivation for this transaction to be other than a financing.

a. **Nominal purchase price and time value of money.** There is no dispute that the value of the aggregate monthly lease payments equals or exceeds the original cost of the Lighting Fixtures. (D.I. 457, Ex. B, Table 1) Indeed, the transaction was structured to repay Duke for the cost of the Lighting Fixtures plus the interest associated with that cost within the term of the MESA.[2] The only "termination right in the MESA requires Pillowtex to pay all remaining payments under the MESA plus an additional amount. (D.I. 457, Ex. A at ¶ 12.2)

b. **Useful life.** The record indicates that the total useful life of the Lighting Fixtures (20 to 25 years) far exceeds the term of the MESA (five to eight years). This factor is less than compelling, however, when viewed in light of the uncontroverted evidence submitted by Pillowtex that the cost of removing and replacing the Lighting Fixtures is economically prohibitive, given the absence of a resale market for such fixtures. (D.I. 746 at 16-17, 31-32; D.I. 1383, Ex. A at ¶ 6)

c. **Form of the transaction.** Pillowtex accounted for the energy projects under the MESA as a utility contract, recording the monthly payments to Duke as a utility expense.

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[2]Although Pillowtex did not submit for the court's consideration specific evidence that the aggregate rental payments have a "present value equaling or exceeding the purchase price of the subject property," In re Edison, 207 B.R. at 814, the court concludes that the transaction, as structured, took into account the time value of money.

Pillowtex has never accounted for the energy projects under the MESA as true leases. The tax savings contemplated by the ESR represented the projected reduction in sales taxes from reduced energy usage. (D.I. 1383, Ex. A at ¶ 5) The MESA is not labeled as a lease.

14. From the above, the court concludes that both the form and the economic realities of the transaction support the debtors' position that the MESA is not a true lease.

15. Neither does the Master Lease between Duke and GECC (whose interests were subsequently assigned to South Trust) constitute a true lease, based on a review of the above factors and the following:

a. South Trust entered into the transaction without any property to lease and, therefore, was acting only as a financier. See Orix Credit Alliance, Inc. v. Pappas, 946 F.2d 1258 (7th Cir. 1991).

b. Duke can terminate the Master Lease prior to the end of its eight-year term only if Duke purchases the Lighting Fixtures or otherwise pays off South Trust. (D.I. 457, Ex. C at Art. XVIII)

c. The court finds that the economic realities of this transaction, as discussed above, would compel Duke to purchase the Lighting Fixtures at their minimal market value rather than incur the substantial cost to remove the Lighting

Fixtures and acquire and install replacement fixtures. Consequently, Duke would become the owner of the Lighting Fixtures at the end of the Master Lease, making the Master Lease a disguised security agreement. Consistent with this reasoning, Duke would abandon the Lighting Fixtures rather than remove and replace them.

Sue L. Robinson
United States District Judge